ORIGINAL

0000039929

050B

BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED
2006 JAN 24 P 3: 24
AZ CORP COMMISSION
DOCUMENT CONTROL

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF DUNCAN RURAL SERVICES CORPORATION FOR A RATE INCREASE.	DOCKET NO. G-02528A-05-0314
IN THE MATTER OF THE APPLICATION OF DUNCAN RURAL SERVICES CORPORATION FOR APPROVAL OF A LOAN IN THE AMOUNT OF $400,000.	DOCKET NO. G-02528A-03-0205 **CLOSING BRIEF**

GALLAGHER & KENNEDY, P.A.
2575 E. CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
(602) 530-8000

Duncan Rural Services Corporation ("DRSC" or the "Association") submits this Closing Brief in support of its rate and long-term debt Applications. DRSC will focus primarily on the four issues on which it and Staff disagree: (1) revenue requirements, (2) rate design, (3) changing the way DRSC administers its gas adjustor clause and (4) the amount of long-term debt the Commission should authorize.

Introduction

The Administrative Law Judge ("ALJ") is very familiar with the difficulties faced by DRSC having heard three of its four rate cases over the past 12 years. For brevity's sake, we will not repeat here the difficulties of its 15-year-plus history as a small, non-profit association delivering gas in Greenlee County (see Opening Statement, HR TR, pp. 7-14). The Association and Staff agree that DRSC needs to address its financial problems.

Mr. Shilling described it this way:

> The other thing I might say, Ms. Rodda, you have been in all of our Duncan Valley rate cases that we have had and you know the struggle that we have had with [the Duncan Valley rate cases]. We had excess funds from the PD settlement. We no longer have those excess funds.
>
> So Duncan Rural is going to have to get to the point very quickly that it can borrow from a third-party lending agency other than Duncan Valley.
>
> ***
>
> Q. [by Ms. Rodda] Okay. All right. So one of my questions I had from before and you just touched on this was, does Duncan Valley electric have the funds to lend...?
>
> A. Today we do but we would not anticipate much more than two to three years that we would be able to fund the cash for Duncan Rural Services. (HR TR, pp. 98-100.)

It is clear that meaningful solutions for the Association must be devised and approved now. Each one of DRSC's recommendations on revenue requirements, rate design, a change in gas clause administration and a realistic level of long-term debt are designed to place the Association in a position that it will be able "to stand on its own two feet" and continue to provide safe, reliable and adequate service to its members.

I. Revenue Requirements

Staff recommends that DRSC begin to build equity. The Association agrees. That is one reason why the Commission should approve the rates it has requested, including two additional 5% step increases to take effect on January 1, 2007 and January 1, 2008.

Attached as Exhibit A is Mr. Wallace's Rejoinder Schedule A-2 (in evidence as Exhibit A-4) which sets forth details on the requests. DRSC asks that the Commission authorize a rate of return of 13.56% (l. 11) on its agreed rate base of $758,057 (l. 10), but that $32,436 (l. 15) of the requested relief be deferred for implementation in 2007 and 2008 as reflected in the two right-hand columns of Exhibit A. This process is similar to the step increases which the ALJ recommended and the Commission authorized for the Arizona Electric Power Cooperative and Southwest Transmission Cooperative last year.

Both Mr. Wallace and Mr. Shilling discussed the multiple reasons supporting the request (HR TR, pp. 52-60, 67-70, 105-106). Briefly to summarize, it is consistent with the Commission's stated preference for smaller and more regular rate increases. It will also save Commission time and resources and avoid about $60-70,000 in expense which DRSC would incur in processing two rate cases. To place those savings in context, they are about the same as the roughly $64,000 in total margins DRSC might earn in 2008 (Ex. A, l. 6, right column) and are almost as much as the Association's one-year capital budget requirement of $80,000.

Historically, there is no disagreement that DRSC revenues simply have not kept pace with its expenses and its required capital expenditures. The revenue requirements request will help address the combined effect of both its dwindling customer base as well as its rising expense levels between the close of the test year and rate implementation. The request assumes a more realistic interest level of 5% on the additional borrowings necessary to repay the currently outstanding advances from Duncan Valley as well as to fund this year's repair and replacement program. About one-third or $5,000 of the $16,000 in deferred rates is needed to pay the increased interest expense on loan funds for this year's capital program. Finally, the Association's request provides a timely, efficient and meaningful response to Staff's recommendation that DRSC should build equity. DRSC requests that the Commission approve the revenue requirements recommendations and 5% step increases set forth on Exhibit A.

II. Rate Design

Attached as Exhibit B are the rates which DRSC asks be authorized (Exhibit A-5). The Association and Staff agree on the monthly service charges for each service category and the service charges set forth at the bottom of the exhibit.[1]

The Staff/DRSC disagreement on rate design focuses on two issues. Staff recommends that (1) there be distinct, as opposed to uniform, commodity rates for each class and (2) the rate design should be changed from the summer/winter rate differential in effect on the system for the past four years and which was approved by the Commission in 2002.

The impact on the irrigation class and on DRSC's revenues is the greatest concern with the Staff proposal. Under its plan, the 250-425 cfh irrigation class contributes roughly <u>eight</u> times as much as the residential class return on rate base (Revised Schedule G-2, Exhibit S-2). As Mr. Wallace testified, DRSC's current and proposed design recognizes that the irrigation class uses very little gas during the peak winter months and does not cause capacity and capital investment system costs. DRSC's rate design also attempts to preserve the revenues from its irrigation customer base which is very price sensitive: "if they drop off the system we will lose the entire revenue from that customer [class]." (HR TR, p. 40, ll. 14-23.) Referring to Staff's Exhibit S-2, that would represent an operating income loss of $25,925 or about <u>60%</u> of the Association's expected total margins from this case.

Mr. Shilling stated that this devastating loss of revenues is not a hypothetical concern:

> This year we had three of our approximately 20 irrigators shift from natural gas to electric permanently, and all of our natural gas customers have the ability to irrigate with electric. They are dual-facility customers.

***

[1] Although not a preferred result, Mr. Wallace testified that the Association could accept Staff's recommendation of 3% as the interest rate on customer deposits (HR TR, pp. 30-31).

Q. [by Mr. Grant] Are they price sensitive?

A. Yes, they are.

Q. Can they also shift the time in which they grow crops or perhaps select different crops to—which grow in different seasons?

A. Yes, they can, and that's part of the reason for the summer-winter differential. We try to discourage our irrigators from irrigating in the wintertime because that would probably make us have to invest more money in plant for the capital and the demand. (HR TR, p. 76, l. 13-p. 77, l. 9.)

In responding to questions from the ALJ, Mr. Irvine indicated that Staff was not aware of this evidence concerning the irrigator's capability and practice of fuel switching in making its rate design recommendation (HR TR, pp. 174-175). Although Staff's well-intentioned objective was to assist residential consumers, the evidence demonstrates it will have just the opposite effect—reducing revenues, increasing necessary capital expenditures and, as a result, increasing rates for the residential class.

Finally, another advantage of the rate design proposed by DRSC is that it has been in effect for the past four years and, thus, meets a key cost-of-service goal: uniformity. It would also avoid a substantial impact on the local school district—the only customer taking service under the greater than 425 cfh rate (A-3, p. 8, ll. 11-21). Rates authorized in this case would take effect after the peak season—minimizing Staff concerns about the winter/summer differential impact (HR TR, pp. 70-71). Further, Mr. Shilling testified that the Association has not received complaints because of the seasonal rate differentials and it offers a levelized bill payment program allowing customers to regularize payments throughout the year (HR TR, p. 84). The Association would request that the Commission approve the rates set forth in Exhibit B.

III. Change Gas Clause Administration Procedures

There is no doubt that one of the primary cash flow and credit strains on the Association has been extremely volatile natural gas prices. The current Purchased Gas Adjustor ("PGA") system of a narrow band of adjustment annually, coupled with surcharge requests when, in DRSC's case, undercollections total $35,000, has outstripped and continues to overwhelm the Association's ability to pay its obligations as they come due. Twice, it has caused sudden, large rate surcharge increases for customers. The current PGA system was designed in the late 1990s when natural gas prices had been stable for several years and were at a fraction of today's levels. While larger companies with greater cash and credit resources may be able to survive under the current system, it just does not work for DRSC.

These are the reasons why DRSC asks that the Commission authorize a change in the way it administers its gas adjustor clause. In order to manage its bank balance as close to zero as possible, DRSC should be allowed to adjust its clause monthly—up or down—by no more than 10 cents per therm based upon its 12-month rolling average cost of gas. Over time, this will allow the Association gradually to move the rate charged closer to its actual cost of gas—minimizing and ultimately eliminating the need for DRSC to carry and finance large under-collected balances. Mr. Shilling testified these balances will reach from $100-150,000 shortly (HR TR, p. 101). The proposal benefits consumers in two ways. First, they avoid the interest costs necessary to finance these massive undercollections. Second, they receive constant, gradual rate signals rather than the abrupt and much larger increases the current narrow annual band plus surcharge system delivers.

Staff opposes the recommendation because it "has the potential to dramatically increase the variability in the PGA rate" (S-6, p. 2, l. 8). However, Mr. Irvine agrees that customers can and do see great variability under the current system (HR TR, p. 167, ll. 4-12). Demonstrative of that fact is that consumers have twice in the recent past seen sudden jumps of 41 cents and 45 cents per therm in just one month—more than four times the variability and volatility allowed under DRSC's proposal. The Association requests that the Commission approve a change in its PGA clause administration procedures as described above.

IV. <u>Long-Term Debt Level</u>

The last issue on which Staff and the Association disagree is the level of long-term debt which should be authorized. DRSC recommends $600,000, while Staff's position is that only about $330,000 should be authorized.

The $98,000 portion of the differential between the DRSC and Staff positions would be used to fund this year's capital repair and replacement program. It essentially updates DRSC's original finance application which was filed in 2003. The Association, however, requested the Commission delay action on the request, because this rate case needed to be processed first in order to provide funds to pay the debt service on the requested debt.

Apparently Staff opposes this request because issuing "any additional long-term debt would further exacerbate Duncan's excessively leveraged capital structure..." (Exhibit S-4, p. 2, ll. 15-16). While this may be true, it doesn't change the fact that additional funds are needed now for required repairs and replacements on the aged system and no one contests that fact. Denial of the request might improve DRSC's equity position on paper, but it will seriously jeopardize its ability to continue to provide safe, reliable and adequate service. Neither the Commission nor Staff nor the Association wants to see a return to the days before this system was purchased when it was in "serious disrepair and...cited by the Staff's pipeline safety section for numerous violations." (Decision No. 58356, p. 3.) The $98,000 in additional long-term debt is necessary to avoid that result.

The remaining approximately $170,000 differential between the DRSC and Staff positions turns on Staff's position that this amount of Duncan Valley Electric Cooperative advances to DRSC funded operating expenses not capital improvements. As a general matter, DRSC does not disagree with Staff that normally loan funds should not be used to fund operating expenses. They should be paid from operating income or, in the case of a for-profit utility, from capital infusions from stockholders. However, as a factual matter, in the case of a non-profit corporation like DRSC, there are, of course, no stockholders and no other source of funds for DRSC to continue to meet its obligations than the advances it received from Duncan Valley. As a legal matter, the statutes expressly give the Commission the authority to authorize debt to cover operating expenses: "<u>except as otherwise permitted in the order</u>, such [loan] purposes are not, wholly or in part, reasonably chargeable to operative expenses or to income." A.R.S. § 40-302.A (emphasis supplied).

This case is an ideal and a unique one for the Commission to exercise that power. The challenges facing the Association have been daunting. It has filed four rate cases in the past 12 years. Each documents the extraordinary challenges it has faced in operating this system, including much larger than expected capital requirement needs and the need to correct its predecessor's billing factor error when discovered, which negated much of the relief granted in one of those cases. DRSC filed a timely request for loan approval of the advances, but had to defer it for processing of this rate case. Duncan Valley and its members stepped in to assist. As already discussed, many of the advances required by DRSC since the last rate case have been because of very high natural gas prices[2] and a PGA recovery mechanism which does not allow timely matching of expense recovery to expense incurrence. All of these factors have been beyond both DRSC and Duncan Valley's control.

The Commission should authorize the additional $600,000 in long-term debt to meet past and current capital expenditure needs and amounts spent in good faith to meet some operating expenses which were beyond DRSC's control. To force a $170,000 capital infusion by Duncan Valley's members under these circumstances is unwarranted and unfair.

On a related matter, Staff has also suggested that advances from Duncan Valley Electric Cooperative to DRSC should be discontinued. While the Association agrees that is an important goal and one of the primary reasons for its positions in this case, Staff's recommendation should not be ordered. Mr. Shilling discussed the fact that even if the rates requested by DRSC are granted, it still will not be able to cash flow operations in certain months and meet its obligations as they come due (HR TR, pp. 79-84). That is particularly true in 2006, because the rates ordered in this matter will not take effect until after the winter peaking season. Therefore, the Association will not have the opportunity to marshal its cash resources in order to carry it through the shoulder and summer months.

Conclusion

DRSC requests that the Commission enter its Order authorizing (1) the revenue requirements and rate increases described in Exhibit A, (2) the rates set forth in Exhibit B, (3) a change in gas adjustor procedures as described in Section III above and (4) $600,000 in long-term debt.

---

[2] For example, Mr. Shilling testified at time of hearing that the under-collected bank balance was $55,000 and would probably increase to $100-150,000 before the recently approved surcharge would begin to reduce that balance (HR TR, pp. 101-102).

RESPECTFULLY SUBMITTED this 24th day of January, 2006.

GALLAGHER & KENNEDY, P.A.

By Michael M. Grant

Michael M. Grant
Todd C. Wiley
2575 East Camelback Road
Phoenix, Arizona 85016-9225
Attorneys for Duncan Rural Services Corporation

Original and fifteen copies filed this 24th day of January, 2006, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copy of the foregoing delivered this 24th day of January, 2006, to:

Jason Gellman, Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copy of the foregoing mailed this 24th day of January, 2006, to:

Jane L. Rodda
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
400 West Congress
Tucson, Arizona 85701-1347

10426-2/1326373

EXHIBIT A

PROPOSED REVENUE INCREASE
SUMMARY

Line No.	Description	Per Books	Test Year As Adjusted	Proposed Rates	Proposed Rates With 5% Inc.	Proposed Rates With 10% Inc.
1a.	Total Base Rate Revenue	$ 644,167	$ 319,136	$ 485,841	$ 502,060	$ 518,278
1b.	Total Other Revenue*	$ 5,210	$ 5,210	$ 5,210	$ 5,210	$ 5,210
1c.	Total Base Rate Revenue and Other Revenue	$ 649,377	$ 324,346	$ 491,051	$ 507,270	$ 523,488
1d.	Plus: Fuel Adjustor Revenue	$ -	$ -	$ -	$ -	$ -
1e.	Total Revenue Before Other Contract Margin Revenue	$ 649,377	$ 324,346	$ 491,051	$ 507,270	$ 523,488
1f.	Other Contract Margin Revenue	$ -	$ -	$ -	$ -	$ -
1g.	***Total Revenue***	$ 649,377	$ 324,346	$ 491,051	$ 507,270	$ 523,488
2.	Operating Expense Before Interest Exp. On L.T. Debt	$ 708,298	$ 371,375	$ 412,943	$ 412,943	$ 420,713
3.	Operating Margin Before Interest Exp. On L.T. Debt	$ (58,921)	$ (47,029)	$ 78,108	$ 94,326	$ 102,774
4.	Interest Expense on Long-Term Debt	$ 14,973	$ 39,187	$ 39,187	$ 39,187	$ 39,187
5.	Non-Operating Margins	$ 110	$ 110	$ 110	$ 110	$ 110
6.	Total/Net Margin	$ (73,784)	$ (86,106)	$ 39,031	$ 55,249	$ 63,697
7.	Total Long-Term Debt Principal Payment	$ 45,305	$ 55,421	$ 55,421	$ 55,421	$ 55,421
8.	Net TIER (Intr Exp on L.T. Debt + Net Margin)/Total Intr Exp on L.T. Debt	(3.93)	(1.20)	2.00	2.41	2.63
9.	DSC (Net Margin + Depr Exp + Intr Exp on L.T. Debt)/ Prin&Int on L.T. Debt	(0.15)	(0.50)	1.35	1.52	1.61
10.	Rate Base	$ 758,057	$ 758,057	$ 758,057	$ 758,057	$ 758,057
11.	% Return on Rate Base (Operating Margin / Rate Base)	-7.77%	-6.20%	10.30%	12.44%	13.56%
12.	**Total Proposed Revenue Increase Over Total Present Rates (Does not include Fuel Adjustor Revenue)**	-		**$ 166,705**	**$ 182,923**	**$ 199,142**
14.	**% Increase In Total Adusted Test Year Revenues**			**25.66%**	**28.16%**	**30.66%**
15.	**Increase In Revenues**				**$ 16,218**	**$ 32,436**

Duncan Rural Services Corporation
Docket No. G-02528A-05-0314
Test Year Ended December 31, 2004

	SUMMARY OF FILING				
	PRESENT RATES		PROPOSED RATES		
Revenues	Per Books	TY as Adjusted	Proposed	Proposed With 5 %	Proposed With 10 %
Sales Revenue of Gas - Base Rates & PGA	$ 644,167	$ 319,136	$ 485,841	$ 502,060	$ 518,278
Other Operating Revenue	$ 5,210	$ 5,210	5,210	5,210	5,210
Total Revenue	$ 649,377	324,346	$ 491,051	$ 507,270	$ 523,488
Expenses					
Purchased Gas	$ 325,260	$ (0)	$ (0)	$ (0)	$ (0)
Distribution Expense - Operation	$ 147,723	$ 154,097	$ 154,097	$ 154,097	$ 154,097
Distribution Expense - Maintenance	$ 52,766	$ 54,824	$ 54,824	$ 54,824	$ 54,824
Consumer Accounts Expense	$ 58,103	$ 60,129	$ 60,129	$ 60,129	$ 60,129
Administrative and General Expense	$ 54,952	$ 56,520	$ 56,520	$ 56,520	$ 56,520
Depreciation and Amortization Expense	$ 49,645	$ 49,645	$ 49,645	$ 49,645	$ 49,645
Tax Expense - Property	$ 19,639	$ 19,639	$ 19,639	$ 19,639	$ 19,639
Tax Expense - Other	$ -	$ -	$ -	$ -	$ -
Tax Expense - Income taxes*	$ (158)	$ (23,846)	$ 17,722	$ 21,474	$ 25,492
Interest Expense - Other	$ 367	$ 367	$ 367	$ 367	$ 367
Total Operating Expenses	$ 708,298	$ 371,375	$ 412,943	$ 416,695	$ 420,713
Interest Expense - Long-term Debt	$ 14,973	$ 39,187	$ 39,187	$ 39,187	$ 39,187
Total Operating Expenses and Int on L.T. Debt	$ 723,271	$ 410,562	$ 452,130	$ 455,882	$ 459,900
OPERATING MARGIN after Intr Exp on L.T. Debt	$ (73,894)	$ (86,216)	$ 38,921	$ 51,387	$ 63,587
Non-Operating Margin					
Interest and Dividend Income	$ 110	$ 110	$ 110	$ 110	$ 110
Capital Credits	$ -	$ -	$ -	$ -	$ -
	$ 110	$ 110	$ 110	$ 110	$ 110
TOTAL/NET MARGINS	$ (73,784)	$ (86,106)	$ 39,031	$ 51,497	$ 63,697

EXHIBIT B

Duncan Rural Services Corporation
Docket No. G-02528A-05-0314
Test Year Ended December 31, 2004

Rejoinder Schedule H-3

RATE DESIGN

METER SIZES	Present Rates	Proposed Rates	Proposed Rates With 5% Incr.	Proposed Rates With 10% Incr.
250 cfh & Below				
Monthly Service Charge	$15.00	$20.00	$20.00	$20.00
Winter Commodity Rate per Therm	$0.44000	$0.73000	$0.77000	$0.81000
Summer Commodity Rate per Therm	$0.15405	$0.26000	$0.27600	$0.28800
Above 250 cfh to 425 cfh				
Monthly Service Charge	$22.50	$30.00	$30.00	$30.00
Winter Commodity Rate per Therm	$0.44000	$0.73000	$0.77000	$0.81000
Summer Commodity Rate per Therm	$0.15405	$0.26000	$0.27600	$0.28800
Above 425 cfh to 1,000 cfh				
Monthly Service Charge	$30.00	$40.00	$40.00	$40.00
Winter Commodity Rate per Therm	$0.44000	$0.73000	$0.77000	$0.81000
Summer Commodity Rate per Therm	$0.15405	$0.26000	$0.27600	$0.28800

Service Charges:	Present Rates	Proposed Rates	Proposed Rates	Proposed Rates
Establishment of Service (Regular Hours)	$ 35.00	$ 35.00	$ 35.00	$ 35.00
Establishment of Service (After Hours)	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Re-establishment/Reconnectiion of Service (Regular Hours)	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Re-establishment/Reconnection of Service (After Hours)	$ 75.00	$ 75.00	$ 75.00	$ 75.00
After Hours Service Calls - Consumer Caused (Per Hour)*	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Meter Re-read Charge (No Charge for Read Error)	$ 30.00	$ 30.00	$ 30.00	$ 30.00
Meter Test Fee	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Insufficient Funds Check	$ 20.00	$ 20.00	$ 20.00	$ 20.00
Interest Rate on Customer Deposits**	3.0%	Variable	Variable	Variable
Late/Deferred Payment (Per Month)	0.0%	1.5%	1.5%	1.5%

* One hour minimum
** Variable Rate based on the Three Month Non-Financial Commercial Paper Rate as published by the Federal Reserve

Base Cost of Gas & Fuel Adjustor Included in Present Rates	$	-
Base Cost of Gas $ Fuel Adjustor Included in Proposed Rates	$	-